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IN THIS ISSUE:

Cautious Responses Greet Conclusion Of North American Trade Pact Talks 1

Japan's Balance Of Payments Surplus Jumps 3

Tokyo Plans Emperor's Trip To China 6

Notes: Gears; Steel 8

Cautious Responses Greet Conclusion Of North American Trade Pact Talks

After 14 months of meetings negotiators from the United States, Canada and Mexico heralded on August 12 the conclusion of talks to link more closely the three economies. The North American Free Trade Agreement worked out by the countries eventually will eliminate all tariffs on industrial and agricultural goods produced by the participants, help safeguard intellectual property rights and remove most barriers to investment in the region. For observers in Japan and other countries, however, concerns remain over whether the free trade arrangement will limit North American trade and investment opportunities for nonparticipants.

Soon after the talks were concluded representatives of the three NAFTA governments set to work on specifics for implementing the pact. Many political and business leaders in North America and outside the region said they would withhold judgment on the agreement until such details are available for examination. Meanwhile, U.S. industry advisory groups are expected to prepare reports for Congress on how the agreement will affect American interests. The reports and the draft text of the agreement will be sent to Capitol Hill in early September, after lawmakers have returned from the August recess. At that point Congress will have 90 calendar days to consider the pact and the trade law changes necessary for implementing it. Once the agreement is signed and implementing legislation is submitted, Congress must vote up or down on the bill within 90 session days.

Many American business leaders welcomed the agreement, apparently concurring with President Bush that "by sweeping aside barriers and expanding trade" NAFTA will make U.S. companies more competitive internationally. Throughout the negotiations, however, a number of

Other industries in Japan similarly have been apprehensive about NAFTA rules of origin. In a report released this June an advisory committee to the Ministry of International Trade and Industry said that the regional content requirements anticipated under NAFTA for color television sets and semiconductors as well as motor vehicles would discriminate against nonsignatories and violate the General Agreement on Tariffs and Trade. Other observers point out that the TV sets turned out by Japanese electronics firms' assembly plants in Mexico already have nearly 60 percent local content. Japanese interests also have been awaiting the outcome of the negotiations covering the financial services sector. NAFTA provisions aimed at opening Mexico's long-closed financial services market are expected to offer new opportunities there for overseas companies as well as firms based in North America.

The Japanese government has taken a cautious stance toward the new free trade arrangement. A statement from the Ministry of Foreign Affairs said that Japan "in principle" welcomes the conclusion of the negotiations. But the statement also underscored Tokyo's position that NAFTA must "strengthen the international free trade system, be fully consistent with the GATT and other international rules as well as with bilateral arrangements, and not raise barriers to third countries, including Japan, in the North American market."

The statement urged NAFTA participants to provide a full explanation of the accord so the Japanese government can evaluate the contents and the implications of the pact. Tokyo's position on NAFTA will be decided only after a careful examination of the agreement, according to the statement. Moreover, Japanese government officials have reiterated their intention of ensuring that NAFTA is consistent with international trade rules; Tokyo will push for a detailed GATT committee review of the pact. The statement also indicated that Japan would like a say in the implementation of the North American trade pact, a role addressed this spring by the Japan-Mexico Commission for the 21st Century (see *JEI Report* No. 21B, June 5, 1992). The official response further stated that Japan "would like to engage in active discussions with countries having a common interest, at the GATT and elsewhere, on the formation of the NAFTA and its impact on the global trade and economy, as well as its effects on the non-NAFTA countries, especially those of the Asia-Pacific region." The Foreign Ministry reportedly has sent a letter expressing Japan's concerns about the proposed trade arrangement to U.S. Trade Representative Carla Hills.

Indicative of the concerns of many of Japan's East Asian neighbors about the impact of NAFTA on their economies was a report released earlier this summer by the Pacific Economic Cooperation Council. PECC cautioned that the North American arrangement "could divert trade and investment from Pacific economies." The Korea Foreign Trade Association recently voiced another common worry in the region in suggesting that exports — for example, South Korea's — will be displaced by products manufactured in Mexico. Singapore, however, has backed NAFTA under the conditions that the arrangement does not create a protectionist trade bloc and adheres to international trade rules. Some observers worry that East Asian economies will push for their own regional trade bloc to counter NAFTA. To date, however, representatives of most governments in the region have argued against closed trade arrangements and have moved toward closer economic cooperation with some caution (see *JEI Report* No. 5B, February 7, 1992).

Margo Grimm

Japan's Balance of Payments Surplus Jumps

A recent Japanese cartoon shows a very sick patient labeled the Japanese economy. In the midst of surgery the doctor, apparently Prime Minister Kiichi Miyazawa, has gone on summer vacation, which leads to an angry reaction on the part of the patient. In fact, Mr. Miyazawa is hard at work seeking a hoped-for cure in the form of an economic stimulus package. The current account statistics for the second quarter, released August 5, point to symptoms of what ails the economy. In the April-June period Japan's surplus by this comprehensive measure of trade rose 53.2 percent from a year earlier (see Table 1).

Table 1: **Japan's Balance of Payments**

(in millions of dollars)

		Trade Balance	Exports (f.o.b.)	Imports (f.o.b.)	Services (net)	Current Account Balance	Long-Term Capital (net)
1987		$96,386	$224,605	$128,219	$-5,702	$87,015	$-136,532
1988		95,012	259,765	164,753	-11,263	79,631	-130,930
1989		76,917	269,570	192,653	-15,526	57,157	-89,246
1990		63,528	280,374	216,846	-22,292	35,761	-43,586
1991		103,044	306,557	203,513	-17,660	72,901	37,057
1989:	I	21,311	66,945	45,634	-3,595	16,064	-5,612
	II	19,794	66,560	46,766	-4,892	14,283	-30,801
	III	19,770	68,157	48,387	-4,023	14,957	-21,559
	IV	16,042	67,908	51,866	-3,016	11,853	-31,274
1990:	I	14,393	65,460	51,067	-701	12,305	-16,086
	II	13,614	65,510	51,896	-5,279	7,892	-18,985
	III	17,149	70,500	53,351	-8,045	7,400	-7,247
	IV	18,372	78,904	60,532	-8,267	8,164	-1,268
1991:	I	20,729	74,978	54,249	-920	10,260	10,707
	II	23,352	71,990	48,638	-4,064	18,664	-7,103
	III	27,745	76,934	49,189	-6,735	19,604	30,843
	IV	31,218	82,655	51,437	-5,941	24,373	2,610
1992:	I	31,368	80,425	49,057	-2,646	27,581	13,406
	II (p)	31,516	78,704	47,188	-2,147	28,599	-12,756

One of the sick patient hypotheses widely believed in the United States gets little support from the numbers. According to this argument, as an economy weakens, imports are likely to fall and exports rise as exporters shift to overseas markets to compensate for sluggish demand at home. The figures for exports and imports shown in the table appear consistent with this argument, but they are misleading. The appreciation of the yen and other price movements over the past year mask the fact that the volume of imports rose more than that of exports, a distortion also observed in the customs-clearance trade statistics released earlier. (For details of this argument, see *JEI Report* No. 28B, July 24, 1992.)

The figures for tourism — included in Table 1 as part of services — are almost as unhelpful for diagnosis. Experts sometimes argue that foreign travel is particularly sensitive to the level of consumer confidence since it represents an easily postponed luxury. If this argument were correct, Japanese consumers would appear to be an optimistic lot; they spent $6.3 billion overseas in the April-June period, 15.7 percent more than a year earlier and a record for the second quarter. A hint of softness in the travel market is apparent, however, if one compares the 1992 figures with those of 1990 on the grounds that the 1991 data reflected lingering reluctance to travel abroad in the wake of the Persian Gulf War. The latest travel expenditures are only 5.9 percent higher than two years ago despite a 19.2 percent appreciation of the yen since the same quarter of 1990. In other words, Japanese overseas travel in the spring declined in real terms compared to the same season two years ago.

Further perusal of the current account statistics would reveal to Mr. Miyazawa something he already knows — that the most apparent weakness in the economy is in capital spending and the financial sector. Japanese firms are even more reluctant to invest overseas in new plant and equipment than they are at home. Direct investment abroad plummeted to just $2.7 billion in the April-June quarter, a 67 percent drop from a year earlier and the lowest quarterly total since the same period in 1986. By contrast, domestic capital spending has been virtually flat in recent quarters. Japanese investors were almost as unenthusiastic about investing in overseas securities, such as stocks and bonds. Compared to a year earlier, they purchased far fewer bonds and became net sellers of equities this past spring. The increase in bond purchases from the anemic level recorded in the first quarter presumably reflected widening yield differentials in favor of foreign bonds (see Table 2).

Table 2: **Japan's Net International Long-Term Securities Transactions**

(in millions of dollars)

		Net Japanese Purchases			Net Foreign Purchases			Net
		Bonds	Stocks	Other*	Bonds	Stocks	Other**	Outflow
1987		$-72,885	$-16,874	$2,002	$6,675	$-42,835	$30,079	$-93,838
1988		-85,812	-2,993	1,856	-21,628	6,810	35,116	-66,651
1989		-94,083	-17,887	-1,208	2,400	6,998	75,746	-28,034
1990		-28,961	-6,256	-4,464	16,991	-13,276	30,938	-5,028
1991		-68,202	-3,630	-2,474	21,241	46,779	47,264	40,978
1989:	I	-14,003	104	577	-1,646	9,004	16,212	10,248
	II	-25,091	-6,108	-776	-587	-6,196	27,501	-11,257
	III	-25,871	-4,795	722	5,403	757	14,123	-9,661
	IV	-29,118	-7,088	-1,731	-770	3,433	17,910	-17,364
1990:	I	-869	-4,946	717	6,182	-11,713	8,246	-2,383
	II	-9,353	-2,153	-954	4,975	838	723	-5,924
	III	-10,905	-459	-2,405	4,790	-3,380	10,485	-1,874
	IV	-7,834	1,302	-1,822	1,044	979	11,484	5,153
1991:	I	-13,356	463	-1,348	1,418	17,486	9,129	13,792
	II	-22,423	-2,840	-1,353	6,348	4,140	11,778	-4,350
	III	-11,120	-134	-94	9,508	15,245	13,317	26,722
	IV	-21,303	-1,119	321	3,967	9,908	13,040	4,814
1992:	I	-4,021	3,975	-1,057	3,540	7,479	3,061	12,977
	II (p)	-14,074	417	1,943	-4,055	256	1,965	-13,548

*Yen-denominated bonds issued in Japan.
**Bonds issued outside of Japan by Japanese institutions.

Note: For outflows a minus sign indicates an increase in assets abroad. For inflows a positive value indicates an increase in Japanese liabilities to foreigners.

Foreign investors, for their part, weighed in with their own resounding voice of no confidence regarding the Japanese economy. Net equity purchases, which had buoyed the weak stock market for months, declined to a mere $0.3 billion, the smallest figure since the fourth quarter of 1990. (This wariness appeared warranted. On August 18 the Nikkei average of 225 stocks listed on the Tokyo Stock Exchange hit its lowest level since early 1986.) Low interest rates in Japan compared

to those available abroad presumably explain foreigners' mammoth $4.1 billion sell-off of Japanese bonds during the second quarter. The change in bond purchase patterns by both Japanese and foreign investors was the biggest single factor in swinging the quarterly flow of securities purchases back to a net outflow for the first time in nine months. Similarly, the overall long-term capital account showed funds flowing overseas again on a quarterly basis after nine months of net inflows.

In short, the April-June current account statistics offer little conclusive evidence that trade in goods and services reflects weak economic conditions in Japan. Direct investment and portfolio data, however, suggest uneasiness on the part of both Japanese and foreign investors. Mr. Miyazawa's counterparts in Washington and elsewhere appear less worried about curing the patient, the Japanese economy, than relieving one of the alleged symptoms, the current account surplus. A widely anticipated economic package involving substantial government spending would treat both the patient and the symptom. Increased spending by Tokyo would boost domestic demand, for example. In addition, by bidding up market interest rates as a result of increased borrowing, the package could increase the demand for yen and raise the value of the Japanese currency, thereby making Japanese exports less competitive and imports more so. (This effect on foreign trade probably would be smaller if the Bank of Japan took measures to offset the rise in interest rates.) In time, the current account surplus would contract, other factors equal. While both the symptoms and the illness could linger for months, a stimulus package eventually could turn out to be just what the doctor ordered.

Douglas Ostrom

Tokyo Plans Emperor's Trip To China

September 29 marks the 20th anniversary of the normalization of Sino-Japan relations, and both Beijing and Tokyo would like to capitalize on the occasion to cement friendly ties. For the commemorative events Beijing has been keenly interested in the great symbolic value that would be represented by a visit by Emperor Akihito. Hotly debated by Japanese politicians behind the scenes, an imperial visit now appears likely to take place this fall. Controversies, however, continue to stir passions on both sides of the Sea of Japan regarding what remarks the emperor will make on his trip.

The development of improved relations with China looms large in Tokyo's vision of its expanded global role. While its democratic allies harshly condemned the crushing by Chinese troops of June 1989 prodemocracy student demonstrations in Tiananmen Square, Tokyo strove not to isolate Beijing by maintaining low-level diplomatic and commercial channels. Although Beijing has not softened significantly its human rights policies since Tiananmen Square, Tokyo argues that its efforts have forestalled even harsher treatment of demonstrators and encouraged Beijing's cooperation on such issues as the United Nations resolutions condemning Iraq during the Persian Gulf crisis and the U.N.-negotiated settlement of the Cambodian civil war.

This open-door policy has kept bilateral trade mainly on the upswing. After declining by 24.1 percent in yen terms in 1990 when Tiananmen Square sanctions were observed at various levels, Japanese exports to China posted a 30.9 percent gain to just under ¥1.2 trillion the following year. The expansion has continued through the first six months of this year, with exports up 32.5 percent to ¥671.7 billion. Imports from China have enjoyed steady growth, rising 12.7 percent in 1990 to ¥1.7 trillion, 10.6 percent in 1991 to ¥1.9 trillion and 13.5 percent during the first half of this year to ¥985.9 billion. In dollar terms, based on Ministry of Finance trade-weighted exchange rates, Japan shipped over $6.1 billion worth of goods to China in 1990 (off 28 percent from the year before). Exports rebounded 40.2 percent in 1991 to nearly $8.6 billion and are up 39.2 percent to $5.2 billion this year for the January-June period. Dollar-based imports, according to MOF calculations, hit $12.1 billion (up 8.1 percent) in 1990, $14.2 billion (up 17.9 percent) in 1991 and $7.6 billion (an 18.9 percent hike) for the first half of 1992. The fact that Japan has run a trade deficit with China in recent years has proved to be more of a political asset than a source of friction in bilateral relations.